Small Business Lending for Economic Development Volume I:

Strategic Responses for Urban Communities

By

Daniel Immergluck
and
Malcolm Bush

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Woodstock Institute
407 S. Dearborn, Chicago, IL 60605
(312) 427-8070
e-mail woodstock@woodstockinst.org
web page http://www.woodstockinst.org
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About the Authors

Daniel Immergluck is Vice-President of the Woodstock Institute. In addition to his work on small business financing programs, Dan conducts research on neighborhood economic trends, lending patterns, and community reinvestment and economic development policy. Dan currently serves as President of the Chicago Association of Neighborhood Development Organizations' City-Wide Development Corporation. Prior to his work at Woodstock, Dan served as Deputy Director of Greater North-Pulaski Development Corporation, an industrial development organization serving Chicago's West and Northwest Sides. Dan also managed the Ohio Department of Development's Edison Seed Development Fund.

Malcolm Bush is President of the Woodstock Institute. Malcolm has extensive experience in urban policy and community reinvestment activity. He has written, taught courses, and spoken widely on community reinvestment policy and action, lending discrimination, and other community development topics. Prior to joining the Institute, Malcolm was Senior Vice-President of Voices for Illinois Children, a statewide advocacy organization. Earlier, he held regular faculty appointments at the University of Chicago and Northwestern University teaching social policy.

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Preface

This publication is intended to provide a foundation for developing and improving small business financing efforts aimed at benefiting residents of modest-income urban neighborhoods. In it, we attempt to capture some of the fundamental, strategic lessons from a year-long Woodstock Institute study of small business lending pro-grams targeting such communities. We also hope to support Community Reinvest-ment Act policy and organizing in the small business arena as well as to draw critical attention to how economic development expenditures are allocated at various levels of government.

In the first part of this report, we explain the importance of small businesses to urban communities and how access to credit is a key issue to the development of such businesses. Specifically, we argue that:

➢ Small business development is a critical component of comprehensive community economic development and community building strategies.
➢ Access to credit for minority-owned businesses and firms located in these areas is an ongoing problem.
➢ The Community Reinvestment Act has not been used to its full potential in the small business arena.
➢ Government business and economic development programs should be directed more toward efforts benefiting modest-income urban communities.

In the second part of the report, we describe a general strategy for developing a local response to small business financing needs in urban areas, including:

➢ Identifying economic development objectives
➢ Defining targeted markets that serve these objectives
➢ Ascertaining financing needs in these markets
➢ Choosing appropriate advocacy and development tools to address these needs

In the last part of the report, we describe four types of advocacy and development tools. More detailed profiles of model programs, together with a discussion of lessons from these programs, are provided in a companion Woodstock Institute publication, *Small Business Lending For Economic Development Volume II: Model Urban Programs.* We hope that these two publications, together, will prove valuable to those seeking to spur small business development for the benefit of modest-income urban residents.

Daniel Immergluck

Malcolm Bush

I. Small Business Lending, Economic Development, and Urban Communities

The Urban Context for Community Economic Development and Reinvestment

The economic and social conditions of many modest-income urban neighborhoods have deteriorated severely over the last 30 years.[1] These communities have lost substantial population and jobs, leading to physical disinvestment, concentrated poverty and crime. These problems have been, in large part, the results of industrial restructuring -- the changes in the technologies of producing goods and services. The strong postwar demand for industrial labor combined with the strength of the union movement had provided a sellers' market in industrial labor across the nation's cities. This meant that even those with weaker connections to unions and job networks could often find living wage jobs that would support their families and provide the income on which their neighborhoods depended. The emergence of international competition and changes in production technologies took their toll on lower-skilled and particularly minority workers. This economic restructuring was accompanied by a spatial restructuring of urban areas, with employers fleeing central city locations for green grass sites.

In addition to the effects of changes in the technology of industry, many urban economic problems have also been supported by a complex of overt and less overt public policies that permit and even subsidize the isolation of the rich from the poor, leaving the poor without ready access to employment opportunities, basic goods, and private and public services. These perverse policies include explicit and implicit subsidies by federal, state and local governments which lure businesses and developers to relocate economic activity out of central cities and into distant, more affluent suburban areas.

In the face of such imposing problems and political obstacles, some suggest that modest-income urban neighborhoods and their residents should be abandoned. But others are working to counter these trends, to increase investment and jobs for residents of central cities, and to rebuild communities. They recognize that policies that work to maintain or increase the social and economic isolation of these neighborhoods carry grave short- and long-term costs to entire metropolitan regions. In the short-term, the lack of access to economic opportunity means more poorly educated workers, more crime, and greater tensions between those with resources and those without. In the long-term, this

...the lack of access to economic opportunity means more poorly educated workers, more crime, and greater tensions between those with resources and those with-out... these neighborhoods will provide the middle-class consumers and home owners that will sustain the economy of tomorrow.

[1] Neighborhoods with median incomes below 80 percent of the metropolitan median are typically classified as low- and moderate-income. These are what we mean by modest-income neighborhoods.

isolation and the continuous fleeing of people and businesses with resources away from modest-income areas cannot be sustained either environmentally or economically. The residents of modest-income areas provide the labor on which regional economies depend, and to a large degree, these neighborhoods will provide the middle-class consumers and homeowners that will sustain the economy of tomorrow. But if these communities continue to be neglected, they will not constitute a strong labor force or have the ability to improve their economic status. The maintenance of economic inefficiencies and inequities will, in the long run, hurt all segments of the metropolitan area.

While attacking these problems requires comprehensive approaches, one part of the problem that needs to be addressed more vigorously is the development of small businesses that provide jobs and investment for communities in need of both. By combining and reshaping the tools provided under the Community Reinvestment Act with federal, state and local economic development programs, community stakeholders can develop sound and effective approaches to spur small businesses, jobs and economic activity that benefit residents or their neighborhoods.

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The Role of Jobs and Economic Development in Community Building

A common priority for modest-income urban neighborhoods is access to jobs for the unemployed, and access to better paying jobs for the working poor. Improving access to better employment opportunities is the most effective way to boost the income of modest-income neighborhood residents and, therefore, to boost the entire economy of the neighborhood. Without decent paying jobs, both near the neighborhood and farther away, other economic development and community building efforts cannot succeed.

While access to jobs is the dominant factor in how much income is brought into a neighborhood, overall community viability depends on many other factors, including the decisions of those with living-wage jobs to remain in the neighborhood. Most economic development efforts build incrementally, and if the quality of life in a neighborhood does not improve as residents gain access to more and better jobs, they are likely to leave the neighborhood before their new income flows into it and impacts housing, retail activity, and the overall quality of life. Without any local economic activity, few households with a choice are likely to stay. If they choose not to, those remaining lose valuable members of their communities. So, while access to jobs is the primary economic development need in modest-income urban neighborhoods, jobs alone are not sufficient for effective community building; other social and economic needs of the community must be attacked simultaneously.

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Due to the interactions between jobs, overall economic opportunity, and the quality of neighborhood life, rebuilding communities requires a comprehensive approach and, in terms of economic development, a mix of objectives: job creation, retail and service business development, and greater business ownership opportunities. Working toward some of these objectives may be more challenging than working toward others, so overall strategies need to be thought through carefully. Some types of development will only occur in conjunction with or subsequent to other development.

Retail development, for example, is unlikely to be successful in distressed neighborhoods that continue to lose substantial portions of their moderate-income population. But retail development may be successful if a neighborhood's moderate-income population is stabilized through the development of appropriately affordable housing and attention to the social needs of the community. An example of this is provided in the north Uptown/south Edgewater neighborhood in Chicago, where a modest-income neighborhood has been able to retain its moderate-income population enabling it to buck the trend of declining retail economies in most modest-income Chicago neighborhoods.[2]

Organizations pursuing particular economic development and community reinvestment efforts may wisely choose to concentrate on one subset of goals for their own agenda. Local merchant groups may be ideally suited for retail development, while coalitions of residents and neighborhood industrialists may be better at addressing neighborhood unemployment issues. But overall, the cumulative causation of urban problems requires a cumulative solution. So a variety of efforts and actors must eventually come together.

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Strategies for Urban Community Economic Development

The focus here is on capital-based strategies for community economic development and, in particular, on increasing lending to small businesses in ways that will benefit modest-income urban neighborhoods. Given the trends of larger employers downsizing and moving farther from urban centers, many look to small business as a promising vehicle for the creation of jobs, income and wealth for residents of these areas. Critical to the overall health of these neighborhoods is the formation and growth of small businesses,

[2] Daniel Immergluck, *Urban Advantages: Sustaining Retail Activity in a Modest-Income Urban Neighborhood*, Woodstock Institute, Chicago, 1995.

located both within and outside of the neighborhoods, that are likely to employ, serve, or be owned by neighborhood residents.

Other strategies, beyond capital-based efforts, are at least as important, if not more important, to economic and small business development aimed at benefiting residents of modest-income neighborhoods. These include labor-based, land-based, management and production-based, and marketing-based strategies. Labor-based strategies focus on training and placing residents of targeted areas in jobs. Such efforts must deal with issues of education and training as well as with issues of employment access -- gaining information on jobs, opening up and building employment networks, battling discrimination, and overcoming barriers of distance between jobs and residents.

Land-based strategies use site-oriented incentives and programs, in part, to address the perverse incentives and regulations that discourage development in job-needy areas and encourage the migration of employers to more affluent, suburban areas. Examples include programs such as the brownfields initiatives for facilitating the reuse of older industrial properties with environmental problems. Also in this category are protective zoning that aims to preserve job-rich land uses and property tax-based tools that work to counter the forces that push jobs and investment out of modest-income areas.

Management and production-based strategies for economic development are relatively new, having gained popularity in the late 1980s, and have been most commonly applied at a statewide or regional level, as opposed to a community level.[3] Such strategies focus on maintaining or improving the competitive advantage of local firms through management audits and efficiency analyses. Partly because many of these efforts have operated at a regional or larger scale, they have often focused on manufacturers and industrial service companies. The National Institute of Standards and Technology's manufacturing technology center program is a principal example of such efforts. In the increasingly global economy, firms that fail to improve their production technologies are more likely to lose business and therefore likely to reduce employment levels.

Marketing-based economic development strategies involve helping firms to identify and serve potential customers. Export promotion and procurement programs are examples of this type of strategy. Procurement programs have been actively used in supporting minority business development. Local buying efforts, in which the products and services of small neighborhood-based firms are marketed to larger local businesses, provide another example of this strategy.

Capital-based strategies, which are of principal concern here, often focus on assisting small business owners with financing the plant, machinery and equipment, and working capital needed to begin, maintain or expand operations. Such strategies might involve the use of both debt and equity financing, or some hybrid of the two. Debt financing involves making loans to firms. Typically, business loans are paid back according to a fixed schedule starting immediately after the loan is made. They are secured by business or personal property and involve no loss in control of the company to the lender.

[3] Peter K. Eisenger, *The Rise of the Entrepreneurial State*, Madison: University of Wisconsin Press, 1988.

Equity financing is riskier for the investor, is typically unsecured, can be paid back at some unspecified later date when profits allow, and often involves giving up significant control of the company to the investor. Due to its riskier nature, the cost of outside equity financing to a business is typically much higher than debt financing. While financial equity is important to small business development, the vast majority of small firms in urban areas will have difficulty affording the costs of outside equity. For most small urban businesses, personal wealth, friends and family will remain the principal foundation for the equity in their business.

An alternative approach that reaches a broader spectrum of firms is to offer debt and debt-equity hybrids that are less expensive. A very common hybrid is subordinated debt, which largely resembles conventional debt but, because it may be secured by weak collateral, begins to resemble equity. Another example of a debt-equity hybrid is a loan for a project that would ordinarily be considered too high-risk for debt financing. To compensate for higher risk, a lender might include an "equity kicker" feature, in which loan repayments are based upon the success of the firm (e.g., a minimum plus some percentage of revenue or profit).

Businesses that become relatively large and are poised to grow into middle-market firms may need access to venture capital. While venture capital is beyond the scope of this report, access to it, especially among minority-owned firms, remains an important issue for urban economic development.

Capital-based efforts can be combined with other types of economic development strategies to increase benefits to local residents. For ex-ample, loan programs can be tied to local hiring and training programs. Similarly, loans can be made after some management assistance or review has occurred, or such assistance may be offered after firms receive financing.

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The Austin Initiative is an example of an economic development effort combining capital-, labor-, and production/management-based strategies. This ambitious undertaking by the Shorebank Corporation, the parent company of the South Shore Bank in Chicago, simultaneously addresses business and labor force development on the far West Side of Chicago. The Austin area is a predominantly African-American neighborhood of more than 110,000 residents, with a 1989 median family income of less than 70 percent of the Chicago area median and a 1990 unemployment rate of 18 percent. The area is home to many manufacturing and industrial service firms, but, overall, only a small portion of the employees at these businesses are residents of the neighborhood. The Initiative combines a business development arm, Shorebank Enterprise, which employs both capital- and management/production strategies to economic development, with the Austin Labor Force Intermediary (ALFI), a facilitator of labor force development activities. Shorebank Enterprise makes loans to small firms through a targeted loan fund, and offers financial incentives for

firms hiring local residents. Recognizing the importance of adopting current practices to the local job base, Shorebank Enterprise also offers technical assistance to small businesses in upgrading their production processes and improving management methods to gain or retain competitiveness. Meanwhile, ALFI works with local schools and job-training organizations to address the labor force needs of neighborhood employers to enable firms to hire more residents.

No serious examination of the problems of urban neighborhoods would suggest that the provision of credit to small businesses, by itself, is sufficient to revitalize the economies of most distressed areas. Investment in small businesses is just one ingredient in the development of local businesses and the economic welfare of local residents. The power of investment flows, however, should not be underestimated.

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Barriers to Small Business Credit in the Urban Context

The lack of access to capital and credit remains a significant barrier to small business development and growth, particularly among minority-owned firms and businesses located in modest-income urban neighborhoods. Research by Timothy Bates of Wayne State University shows that levels of credit and capital are key determinants of business viability for small, young firms.[4] Faith Ando of the University of California at Los Angeles has found that African-American firms, on average, actually have lower debt-to-equity ratios than white-owned firms, which could impede their development.[5]

The importance of credit to firm viability makes access to credit a key issue. Minority-owned firms suffer from poor access to bank credit, even after controlling for business characteristics. Using data from the 1987 U.S. Census Bureau's Characteristics of Business Ownership database, Bates has found that small, young African-American-owned firms are able to leverage only $.89 of debt for every dollar of owner equity, while small, young, white-owned firms are able to obtain $1.79 of debt per dollar of equity, even after controlling for age and management experience.[6]

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[4] Timothy Bates, *Banking on Black Business*, Joint Center for Political and Economic Studies, 1993.

[5] Faith Ando, *An Analysis of Access to Bank Credit*, Center for Afro-American Studies, University of California at Los Angeles, 1988.

[6] Timothy Bates, *Banking on Black Business*, 1993.

Ando surveyed firms in business at least two years and controlled for a variety of credit risk factors including the firms' cre-dit ratings. Her study corroborates Bates' finding that African-Americans have in-ferior access to business credit.[7]

Bates has also found that the location of a business is an even more important factor in access to credit than minority ownership status, with firms located in minority neighborhoods having inferior access to credit. This finding was corroborated by a 1993 survey of small business owners in the Chicago area by Yankelovich Partners and sponsored by a consortium of large Chicago-based banks. Yankelovich found that firms in modest-income census tracts, which tend to be largely minority, reported lack of access to credit to be a "very serious problem" almost twice as often as firms located in upper-income tracts (29 percent to 16 percent), and firms in minority tracts reported lack of access to credit as a very serious problem two-and-one-half times more often than firms in predominantly white tracts (38 percent to 15 percent). Yankelovich also found that, among respondents ever applying for a bank loan, applicants from upper-income tracts received the full amount of their full loan request at a 40 percent higher rate than applicants whose businesses were located in modest-income tracts (88 percent versus 63 percent). Moreover, small businesses in modest-income tracts were substantially less likely than those in upper-income tracts to have applied for a bank loan (76 percent versus 88 percent).[8]

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Studies based on surveys can never capture all of the factors that are appropriately or inappropriately considered in the granting of business loans. Some businesses in modest-income areas and minority-owned firms might be expected to face greater business risks and poorer cash flow, and these factors may not be adequately controlled for in any particular study. Retail and personal service businesses, for example, should be expected to have greater difficulty thriving in those neighborhoods that are losing substantial population and personal income. But the prospects for business success hinge, in part, precisely on the owners' ability to gain adequate capital and credit.

Reasons Behind the Racial and Geographic Barriers to Small Business Credit

The reasons that banks make fewer loans to minority-owned businesses and businesses in modest-income areas are varied and confounding. In the most extreme cases, bank management may perceive certain neighborhoods and ethnic and racial groups to be high-risk without examining particular businesses and opportunities, and then choose to avoid doing business with entire communities. Such behavior constitutes blatant redlining or discrimination, violates the law, and necessitates the vigorous enforcement of the Equal Credit Opportunity Act and the Community Reinvestment Act.

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[7] Faith Ando, 1988.

[8] Yankelovich Partners, *Identifying the Unmet Credit Needs of Small Businesses in Cook County,* Chicago, October, 1993.

Another contribution to banks' poor attention to underserved markets lies in the fact that many banks are less familiar, and so less comfortable, with the business environments in which these firms operate. Leonard Nakamura of the Philadelphia Federal Reserve Bank suggests that one part of the problem is a lack of "information externalities," that more vital com-mercial lending environments provide.[9] For most banks, the commercial lending process continues to be relationship-based, with lenders relying on intimate knowledge of their borrowers to minimize the uncertainty they encounter in making loans. These close relationships provide lenders with the sort of detailed knowledge of their borrowers that is not available through credit reports or other outside sources. And once a firm establishes such a re-lationship, it can rely on that contact to secure additional financing from other sources. Thus, commercial lending itself leads to a climate for more lending.

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The importance of relationships and the information they create must be recognized in addressing small business access to credit. The withdrawal of banks from serving minority-owned businesses or modest-income areas puts these businesses and areas at a severe disadvantage in the market for credit. This may cause the first banks reentering these markets in a substantial way to face extraordinary uncertainties and perceived risks. Therefore, innovative community development lenders look to economic development finance tools to mitigate these perceived risks. Among the best known for this strategy is the South Shore Bank in Chicago, a heavy user of SBA 7(a) guarantees for its small business loans.

Contributing to the problem of inadequate information is the fact that many banks continue to operate in socially conservative cultures that clash with less conventional business practices and unfamiliar types of borrowers. Large gaps remain between the racial, ethnic and cultural make-up of most bank lending staffs and that of modest-income urban neighborhoods and minority businesses. Businessmen, like the population at large, rely upon social and business networks that are often segmented racially and ethnically. Even when banks seek to penetrate these markets and the networks which operate within them, they may be met with substantial distrust.

Bankers often do not understand the business environment of many minority and modest-income neighborhoods and, consequently, may undervalue the business opportunities and assets located in these areas. Businesses that will do well in minority and modest-income neighborhoods may look very dif-ferent from those that succeed in the homogeneous strip malls of suburbia. Michael

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[9] Leonard Nakamura, "Information Externalities: Why Lending May Sometimes Need a Jump Start," *Philadelphia Federal Reserve Business Review*, January-February, 1993.

Porter of Harvard Business School points to the competitive advantage of the inner city for certain kinds of industry and commerce.[10] Modest-income neighborhoods, for example, often have lower median household incomes, but also have much greater population densities, superior transportation, and proximity to many commercial customers. Many of these neighborhoods also offer particular cultural and ethnic business opportunities not available elsewhere.

Interstate Banking and Growing Challenges to Small Business Access to Credit

An increasingly important factor in the availability of credit for minority-owned businesses and small firms in modest-income neighborhoods is the rapidly changing structure of the banking industry. Banks, like many large corporations, are cutting costs. Following the losses on large commercial real estate projects of the 1980s, they have become focused on maintaining portfolios with very low loss rates. Over the last 30 years, modest-income neighborhoods have seen bank branches close down while the number of check-cashing outlets and pawn shops has skyrocketed. Recently, U.S. News and World Report calculated from Federal Deposit Insurance Corporation records for 12 major cities that the ratio of banks in minority neighborhoods to those in white neighborhoods fell from 1:1 to less than 3:5 over the last 20 years, even after controlling for population changes.[11] At the same time, electronic banking is forcing banks to re-examine the number and distribution of their branches.

With the passage of the 1994 Interstate Branching Act, the banking industry is beginning to experience an increasing wave of mergers and consolidation. Because traditional commercial lending relies on interpersonal relationships, the consolidation and centralization of the banking industry could seriously harm access to small business credit, especially for businesses who are already poorly served by the banking industry. Traditionally, commercial banks have been the primary provider of financing for small businesses, and although finance companies have assumed a more significant share of the small business lending market, banks are likely to remain the dominant lender to small businesses for a considerable period of time. But, as full interstate banking takes effect, banks become larger, and credit decisions become more centralized and uniform, the barriers to credit faced by minority-owned businesses and small businesses in modest-income areas are likely to increase.

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A recent study by economists at the Federal Reserve Bank of Boston found that, in 11 out of 13 bank mergers examined by the authors, the combined small business loans as a

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[10] Michael Porter, "The Competitive Advantage of the Inner-City," Harvard Business School Working Paper, November, 1994.

[11] "The New Redlining," *U.S. News and World Report*, April 17, 1995, pp. 51-58.

percentage of pooled bank assets declined over a one year period.[12] This trend is reflected in the opinions of many small business owners. A 1994 IBM Consulting Group survey of almost 1,000 firms in the Chicago area with sales between $3 million and $15 million found that 47 percent of the respondents believe that mergers cause the quality of bank customer service to deteriorate, with only 21 percent believing that mergers improve customer service.[13]

In order to maintain or improve access to credit in such an environment, strategies must be developed. These strategies must maintain access to a full range of products and services for targeted markets and must provide for mechanisms to address the unique barriers to credit faced in these markets.

The Connection Between the Community Reinvestment Act and Economic Development Finance

The 1977 Community Reinvestment Act (CRA) requires banks to provide credit to all parts of its service area, including modest-income areas. Despite the importance of small business development and the barriers to credit that exist in this arena, CRA has been used much more effectively in housing development than in the small business arena. This has been due, in part, to the availability of mort-gage lending data and the unavailability of small business lending data. CRA has been crucial both to spurring increased conventional residential lending by banks and to encouraging the development and sustenance of a new set of financing tools for housing development. This combination created the supply of capital and credit that allowed affordable housing to become a more viable development opportunity.

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The presence of CRA, has had both a direct and indirect effect in this arena. *Directly*, many banks have become much more active in residential lending in modest-income areas, through establishing low down-payment programs, initiating targeted lending programs, working with community-based organizations, and utilizing subsidies. *Indirectly*, CRA has had a significant effect on promoting programs and policies that support the development of affordable housing. Banks have become active partners with local and national organizations in supporting affordable housing policies and programs. CRA has encouraged the development of such programs as the low-income housing tax credit that have lowered the cost of housing development in modest-income neighborhoods and have encouraged, in some places, a boom in affordable housing development. Many banks, and some regulators, have supported these programs because they know that they can be helpful to banks' CRA efforts. With bank support came the

[12] Joe Peek and Eric Rosengren, “The Effects of Interstate Branching on Small Business Lending,” Federal Reserve Bank of Boston, May, 1995.

[13] *Survey of Small Business Executives: Perspectives on Banking and Financing,* Chicago: IBM Consulting Group, 1995.

support of the larger corporate community. Over the last 20 years, housing investment in modest-income neighborhoods, assisted by appropriate government subsidy and support, has become an accepted form of corporate involvement in urban development.

The strong direct and indirect effects of CRA on housing development have often been most obvious in the multifamily housing arena. In Chicago, for example, the number of multi-family loans increased citywide from a level of 400-500 loans per year in 1983-1984 to approximately 1,500 per year by the late 1980s.[14]

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Unfortunately, CRA has not had as strong an impact on small business development. It can be used to increase the amount of conventional small business lending banks do in targeted areas. But CRA can also be used by stake-holders to encourage financial institutions to work with government programs and com-munity development lenders that will, in turn, enable them to do high-impact lending in underserved markets. Banks can work with government and nonprofits to design new economic development products and services. New CRA regulations will encourage banks to do more in the small business arena and will provide explicit credit for investments in targeted economic development programs.

To combine CRA and development finance tools most effectively, stakeholders and lenders must know more about the best tools for reaching businesses in urban neighborhoods in cost-effective ways. These might include innovative bank programs, revolving loan funds, and the use of government credit enhancements. Certainly, CRA has already been critical to spurring the development of targeted lending efforts by banks, the formation of single and multibank community development corporations, which are specially regulated bank-owned lending entities, and the support of public and community economic development lending programs.[15] But these efforts pale in comparison to housing development activities

Government-sponsored economic development programs can and should be used more to complement innovative lending priorities by banks, bank consortia and community-based lenders to boost business development in these markets. While this strategy will not comprehensively address the economic development issues facing modest-income com-munities, it does deal with one critical and necessary component to economic development and job creation: access to business credit and development finance.

Redirecting Economic Development Programs

[14] Sidra Goldwater and Malcolm Bush, *CRA Boosts Multifamily Housing Loans in Chicago*, Woodstock Institute, May 1995.

[15] For detailed descriptions of model programs, see Daniel Immergluck and Samantha Weinstein, *Small Business Lending for Economic Development II: Model Urban Programs,* Woodstock Institute, 1995, a companion document to this report.

Some portion of the billions in government dollars being used in the name of economic development but not serving modest-income communities can be redirected to serve businesses that employ, serve, or are owned by residents of these areas. While many government economic development expenditures are appropriate, two questions must be addressed in examining these programs: First, would the development that was supposedly spurred by the subsidy have occurred without the subsidy? Second, who are the beneficiaries of the subsidized activity? In particular, do the programs target communities most in need of economic development?

It is the second question that is of greater concern here. Unfortunately, while there are many efforts to evaluate whether programs create adequate numbers of jobs or development, there is often less concern with identifying the beneficiaries of these efforts, either in terms of individuals or communities.

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The resources at stake here are significant. Although many explicit federal economic development subsidies are buried in the budgets of various federal agencies, the annual expenditure budgets for agencies and programs with economic development as a primary mission, including the Small Business Administration, the Economic Development Administration, the Community Development Block Grant Program, and the Department of Commerce exceeded $11 billion in fiscal year 1995. Moreover, this figure does not account for significant additional leverage. For example, the Small Business Administration, with its annual budget of $800 million, guarantees approximately $7 billion in small business loans annually.

State and local governments also spend heavily on economic development, with total expenditures conservatively estimated at approximately $10-12 billion.[16] The most common form of expenditure is via foregone tax revenues through tax abatement or incentive programs. The vast majority of states offer a set of tax incentives for capital expenditures or job creation. However, many states do not even track the degree to which tax incentives are used. States and localities also use non-tax incentives and subsidies, including industrial revenue bonds, loan and grant programs, and job training subsidies. The number of state-chartered venture capital programs, infrastructure assistance programs, and other business incentive programs grew by more than 100 percent from 1983 to 1989.[17]

These programs, involving federal, state and local governments, sometimes subsidize the relocation of industry out of job-hungry cities and older suburbs and into newer suburbs.

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[16] Timothy Bartik, "Better Evaluation is Needed for Economic Development Programs to Thrive," *Economic Development Quarterly*, Volume 8, No. 2, May 1994, 99-106. Bartik argues that state and local spending on such programs is probably less than $12 billion annually, although the lack of consistent and comprehensive data, especially on spending by smaller governments, might lead others to argue that this is an overly conservative estimate.

[17] William Schweke, Carl Rist and Brian Dabson, *Bidding for Business: Are Cities and States Selling Themselves Short?*, Corporation for Enterprise Development, 1994.

Often, they are used to induce large businesses to remain in or move into an area, without strong evidence that the firm would behave differently without the incentive or that it will hire local residents. Other times, programs are not adequately targeted toward underserved markets. For example, the federal SBA 7(a) program, the largest program of credit enhancements for small businesses in the country, is not targeted in any significant way toward modest-income urban neighborhoods. Woodstock Institute research on SBA 7(a) lending in the San Antonio area shows that, while lower-income zip codes contained approximately 55 percent of nonmanufacturing establishments and 54 percent of these firms sales and receipts, these zip codes received only 34 percent of the 7(a) loans and 33 percent of the loan dollars obtained by nonmanufacturing firms in the area from December, 1993 through November of 1994.[18]

A modest redirection of federal and state economic development expenditures toward the development in distressed urban areas would yield significant results. These programs, in combination with private sector lending and other strategies, can go far toward supporting development and jobs in these areas. As in housing, economic development finance policies and CRA efforts can complement each other in spurring commercial enterprise and jobs in urban neighborhoods. CRA can directly increase the private lending needed to complement such programs, as well as encourage bankers and the corporate community to support economic development policy that serves modest-income urban neighborhoods.

...economic development finance policies and CRA efforts can complement each other in spurring commercial enterprise and jobs in urban neighborhoods.

[18] Daniel Immergluck, *Moving to Economic Development: A New Goal for SBA Loan Programs*, Woodstock Institute, August, 1995.

II. Small Business Lending for Stronger Community Economies

In order to promote small business lending that benefits modest-income urban areas, community stakeholders can develop overall strategies through the following steps:

1) ***Identify*** the Economic Development Objectives
2) ***Define*** the Targeted Markets
3) ***Ascertain*** the Financing Needs and Gaps in These Markets
4) ***Choose*** the Best Tool for Meeting the Needs and Filling the Gaps

*Step 1: **Identify** the Economic Development Objectives*

The first step in any economic development effort is to identify the desired outcomes--the ultimate objectives of the effort. This, in turn, requires understanding how different types of small business development can affect the economic welfare of the targeted communities. Any one program, even if it is successful, is unlikely to address the entire spectrum of economic development needs in an area. For example, a lending program may be aimed at meeting the needs of small businesses, including retailers, service firms and small manufacturers, but may not address issues relating to larger employers in a community. This does not mean that these larger employers are not important to the area and its residents. Rather, targeting smaller companies may simply recognize that the financial needs of larger firms are already being adequately served.

Similarly, small businesses may provide key employment opportunities for lower-skilled workers and neighborhood youth even if the smaller firms in an area do not provide a large portion of resident employment. These businesses may also be key providers of goods and services to these neighborhoods. Other benefits of small business activity include drawing in other commercial activity, supporting neighborhood claims on public infrastructure and services, and providing an environment conducive to business formation, including business ownership opportunities for residents.

Small business financing models can be designed to meet various economic development objectives of modest-income neighborhoods, including:

- ➢ Near-term positive impacts on the employment of adult residents of the targeted area
- ➢ Near-term impacts on the employment of youth and part-time workers who live in the targeted area
- ➢ Near-term impacts on the local retail and services economy, resulting in increased access to goods and services
- ➢ Near-term impacts on public services, including infrastructure and police, and the avoidance of physical disinvestment and property abandonment
- ➢ Near-term impacts on business ownership opportunities
- ➢ Longer-term employment impacts

Often, one program will address only one or two of these objectives. Other times, more comprehensive efforts are appropriate and possible with available resources.

*Step 2: **Define** the Targeted Markets*

Most stakeholder groups work with scarce resources, so they need to define the segments of the small business economy which significantly affect the objectives defined in the previous step.

The first task in defining targeted markets is to recognize the types of firms likely to make a significant impact on one or more of the objectives identified in Step 1. An increase in the number of small retail and consumer service businesses serving primarily modest-income neighborhood residents, for example, is not likely to have a sizable, near-term impact on the employment prospects of neighborhood adults seeking living-wage, full-time work. These types of businesses, however, can be important to the overall quality of life in the community. Without these businesses, modest-income neighborhoods become less viable. Residents who attain new or better jobs may simply choose to move to more vital areas, where goods and services are more abundant. A vital retail and service economy also generates jobs for youth and part-time workers, who are less likely to find or search for jobs in more distant locations.
Groups looking to increase the quantity and quality of nearby jobs may choose not to address the needs of small retailers and consumer service businesses, but those concerned about the availability of goods and services in their neighborhoods might. The key is to use the results of Step 1 to identify the broad types of firms that are to be financed. If business formation and ownership for modest-income residents is the desired objective, the manufacturing sector, with its substantial start-up capital costs may not prove very promising. On the other hand, manufacturing may provide ample employment opportunities for neighborhood residents. Similarly, financing high-technology firms with few entry level positions may do little to reduce unemployment in areas with lower-skilled workforces. The education and training barriers may be too great.

Community development stakeholders must decide whether they want to adopt a geographical, minority-business, or sectoral approach, or some combination of the three. These approaches can best be understood in the context of a particular set of objectives. For job creation and job access objectives, the three approaches are described as follows:

A) *Geographic*, or place-based, approaches recognize that distance can be a barrier to job access for residents of modest-income neighborhoods, and that businesses in these areas may suffer from inferior access to financing and other development barriers.[19] These approaches target lending to businesses located in or near

[19] A great deal of recent research suggests that distance and commuting time are serious barriers to employment for residents of modest-income urban neighborhoods. This research is perhaps best summarized by Keith Ihlanfeldt in *Job Accessibility and the Employment and School Enrollment of Teenagers*, Kalamazoo: Upjohn Institute, 1992. Ihlanfeldt finds that distance may account for as much as one-third of the employment rate difference between minority and nonminority youth.

modest-income neighborhoods to improve the employment prospects of neighborhood residents. Such programs might also include “best efforts” or “first-source” hiring commitments, in which firms receiving loans agree to make best efforts to hire local residents. Geographic approaches are also typically used to develop retail and service businesses, to increase business ownership opportunities, and to induce greater public sector services and attention to an area.

B) *Minority business* approaches recognize that minority-owned firms hire minorities at disproportionately higher rates than nonminority-owned firms. The available research suggests that even minority-owned firms located in nonminority neighborhoods hire minorities at higher rates than nonminority-owned firms in minority neighborhoods. This is especially true of African-American firms. Substantial evidence suggests that racial discrimination and poor access to employment networks explains much of the inferior access to jobs encountered by urban African-Americans.[20] Minority business approaches often aim to address business ownership and wealth creation oppor-tunities as well as job creation and access.

C) *Sectoral,* or targeted-industry, approaches recognize that certain industries offer particular economic development opportunities and may also entail some unique complexities and challenges. These approaches explicitly recognize that labor markets are substantially, though not entirely, metropolitan in nature and aim to improve job opportunities in an industry across a metropolitan area. Capital-based sectoral strategies are particularly appropriate for industries that face particular financing barriers.

These approaches are not mutually exclusive. They can be used together to address similar objectives. But there may be pragmatic reasons, including resource constraints, for focusing on only one or two approaches.

Geographic approaches are especially appropriate for groups concerned with a specific neighborhood or set of neighborhoods. Firms in the targeted area are more likely to benefit residents of the area than firms in other locations, other things being equal. Even though minority-owned firms employ minorities at higher rates than nonminority-owned firms, job creation in or near a particular neighborhood is likely to benefit residents of the neighborhood more than job creation at minority-owned firms that are far away. A small, nonminority-owned firm located in a minority neighborhood, for example, will tend to employ more residents of that *particular* neighborhood than will a similarly sized minority-owned firm located 25 miles away.

Geographic approaches do pose potential risks. Many modest-income and minority neigh-borhoods continue to see declining population and real incomes and suffer disproportionately during regional economic downturns. So firms serving these markets

[20] See Timothy Bates, *Banking on Black Business*, 1993, for evidence on the tendency of minority-owned firms to hire minorities at greater rates than nonminority-owned firms. For a good review of race-based employment access problems, see Harry J. Holzer, “Black Employment Problems: New Evidence, Old Questions.” in *Journal of Policy Analysis and Management*, Volume 13, No. 4, 1992, page 699-722.

alone, as many small retailers do, are particularly vulnerable. Therefore, lenders should not focus too much on such firms. In fact, local groups should foster the development of firms that sell to customers outside of the neighborhood, thus increasing the net benefit of local businesses to the neighborhood.

Purely minority, nongeographic approaches are especially appropriate when targeting the overall job market for residents of *all* minority neighborhoods in a metropolitan area. A small, minority-owned firm is likely to employ a larger share of a metropolitan area's minority residents than a similar nonminority-owned firm, even one located in a minority neighborhood.

Like the geographic approach, the minority business approach requires some caution. Because minority-owned businesses continue to suffer from discrimination and lack of access to business contacts beyond financing problems, they may be susceptible to economic and public policy changes. Lenders who lend only to minority-owned businesses, for example, may face higher risks due to roll-backs of affirmative action programs. One way to hedge against such risks is to diversify lending to include some nonminority-owned firms that commit to hiring minorities or to serving the economic needs of minority residents.

Sectoral approaches are perhaps the least common among small business financing approaches and are relatively new. These approaches target industries that offer significant prospects for growth and decent job opportunities for modest-income workers. Typically, they target geographic areas larger than neighborhoods or groups of neighborhoods. These approaches, like the others, entail potentially higher risks as well as higher economic development returns. Lending to particular sectors can increase the risk of the entire portfolio. While greater knowledge of the sector can reduce lender uncertainty, the inherent business risk of the sector must still be considered.

A strong example of a sectoral approach to business financing is a day care financing program operated by the Center for Community Self-Help in North Carolina. Self-Help is a 25-year-old nonprofit community development financial institution that works to increase economic opportunity for financially disadvantaged residents of North Carolina. Self-Help, which includes the Self-Help Credit Union and the Self-Help Ventures Fund, makes small business and housing loans in rural and urban parts of North Carolina.

In addition to its regular business and housing finance programs, Self Help has developed a specialized daycare focus which enables it to have an impact on this important industry, promote business development among modest-income North Carolinians, and contribute to daycare policy development at a state and local level. Daycare is both an important issue to the employability of modest-income residents in North Carolina and a business development opportunity. By specializing, Self-Help is able to master the complex legal and regulatory environment that day care operators face. This helps the lender mitigate risks as well as allowing it to provide technical assistance to its borrowers.

*Step 3: **Ascertain** the Financing Needs and Gaps in These Markets*

After identifying the market to be served, stakeholders need to identify the specific nature of the financing that will help firms develop in ways that promote the desired objectives. Too often this is done before Steps 1 and 2, with the result being poorly focused programs that may not serve any objective well.

In determining credit needs of a particular market, it is important to distinguish between conventional and unconventional financing types. Conventional loans include loans to small businesses that typical banks make in most parts of the metropolitan area. These are loans that are clearly profitable for all banks to make, but are not always offered uniformly in all neighborhoods or to minority business owners.

A second type of small business financing are loans that entail a conventional level of risk but that many banks, for a variety of reasons, find relatively unprofitable. A common example is a business loan of less than $50,000. In many urban areas, such loans are considered relatively small, and many banks have difficulty making a substantial profit on them. These low profit margins may be partially due to banks, and their regulators, inappropriately applying the same extensive oversight and credit policies to small loans as they do to very large loans. But small loans, on average, are unlikely to prove as profitable as larger loans. And this difference is likely to be greater for banks accustomed to making larger loans.

Other loans in this second category include those to businesses that are less sophisticated in their bookkeeping and financial systems. Banks may incur more costs in dealing with such borrowers. If they are not able to reduce these costs, they may be discouraged from making these types of loans. But many banks have found ways of working with outside organizations or have set up specialized units to reduce and contain such costs. If banks make loans that offer large profits, they should be expected to make a reasonable share of the loans that are somewhat less profitable. Smaller firms need financing to get to their next stage of development. CRA can be a particularly effective tool in encouraging banks to make these kinds of loans.

A third type of loan is one that entails unusual levels of risk or uncertainty that a bank may be unwilling to absorb alone. Businesses seeking longer term financing and smaller annual payments with fixed interest rates may find banks unwilling to take on the risks of long-term commitments, especially in changing interest rate environments. Businesses with less collateral than banks typically require may also have a hard time finding financing. These businesses will often require some sort of credit enhancement, perhaps a guarantee or a subordinate loan, to become bankable. These financing needs can often be met with economic development financing tools. But almost all such programs require some bank participation, so banks must be encouraged to utilize economic development tools, and they can be encouraged to do so through CRA advocacy.

Stakeholders must determine which financing needs within the targeted markets are already well-served, which types are not, and which types of financing can be increased, perhaps in cooperation with private- and public-sector partners. For example, a 1,000-employee firm in a targeted neighborhood is unlikely to have any unmet financing needs that can be met by an economic development or community reinvestment effort.

Stakeholders need to identify both the demand and supply of conventional small business loans and development financing in the context of the economic development objectives identified in Step 1. Are established, small, firms seeking relatively larger loans being better served than smaller, younger firms seeking smaller loans? If so, stakeholder efforts may have more impact if they address the needs of smaller firms. On the other hand, if stakeholders are interested in having some substantial, near-term impact on the employment prospects of residents, they should pay some attention to more established, larger firms poised for expansion.

Assessing the credit needs of small firms can be done through a variety of approaches. One characteristic of successful programs is the strong involvement of the banking and small business community. While many bankers may be reluctant to admit explicitly that their industry is not adequately serving a segment of the market, they can be extremely valuable in identifying and designing tools that help them serve such markets. Bankers' perspectives on what discourages or encourages them from calling on businesses and making loans are important to the analysis of credit needs. Some bankers recognize the problems caused by cultural and racial gaps between themselves and the targeted firms and their frequent lack of familiarity with business environments in modest-income neighborhoods. The experiences and opinions of small businesses, including those who have obtained adequate financing for their businesses and those who have not, are also important.

Focus groups are a useful tool for conducting such credit needs assessments. Important questions for both bankers, small business persons, and other community stakeholders include:

- ➢ Are banks serving all segments of the metropolitan area uniformly?
- ➢ What are the common reasons that firms are turned down for financing?
- ➢ What types of credit enhancements or services are most needed by targeted firms?

Another method used in evaluating small business access to credit is to gather and analyze the available data on small business lending in the targeted area. Unfortunately, current banking regulations do not provide for the disclosure of lending data for particular banks at areas below the metropolitan level or of information on the race or gender of borrowers. However, data can typically be collected for many public-sector business loan programs, and these data may often include the names of participating financial institutions. The U.S. Small Business Administration and many state and local government agencies must, under freedom of information laws, provide data on their lending activity. These data can provide valuable information on the lending patterns and practices of both banks and government agencies, and can be used to address some particular questions, such as:

- ➢ *Are government economic development finance programs serving modest-income areas and minority-owned firms as well as upper-income areas and nonminority-owned firms?*

  To address this question, the number of loans made by the agency can be compared to the number of businesses in the area serviced by the lending agency. Try to take into account the different size and types of companies in different areas. Is the rate of

lending in modest-income areas substantially above the rate for the entire program area? Do the same sort of analysis comparing loans to minority-owned firms to those for nonminority-owned firms. The results of this sort of analysis lead to questions of how the program is marketed, whether there are hidden biases in the program, and whether the program addresses the financing needs of businesses in the targeted markets. In cases where banks are the primary initiator of the lending activity (e.g., loan guarantee programs), this analysis can also suggest whether the banking industry as a whole is adequately serving the targeted market.

➢ *Are participating lenders in government lending programs serving modest-income areas and minority-owned firms as well as upper-income areas and nonminority-owned firms?*

Compare the ratio of a particular bank's loans to businesses in modest-income areas to the rate for the entire program. For example, if two-thirds of all loans under a program are made to businesses in modest-income areas, but only one-third of the bank's loans go to such areas, the bank is not using the program for sound economic development purposes and may be poorly serving the credit needs of modest-income areas. Of course, some banks are located near few modest-income areas, but if they serve few such areas they should not be substantial users of government economic development programs. Repeat this analysis for loans to minority-owned businesses versus loans to nonminority-owned businesses.

The Woodstock Institute recently evaluated the pattern of small business loan guarantees made by the U.S. Small Business Administration in San Antonio, Texas. San Antonio was chosen because it was the site where an important modification of the agency's principal loan program, the 7(a) guaranty, was piloted in late 1993. To determine the impact of the "LowDoc" program, on financing of small businesses in urban markets, SBA data was obtained for 7(a) guaranteed loans in the San Antonio area from one year prior to the program's introduction in November, 1993 through one year after its introduction.

The Institute's analysis showed that the distribution of SBA lending in San Antonio is skewed away from lower-income and minority neighborhoods. This bias was significant prior to LowDoc and was aggravated after the program's introduction. In the year before LowDoc, nonmanufacturing firms in lower-income zip codes received 39 percent of the 7(a) loans and 43 percent of loan dollars, despite these zip codes having 55 percent of the nonmanufacturing establishments and 54 percent of the sales and receipts. In the year after LowDoc, the pattern worsened, with firms in lower-income zip codes obtaining only 34 percent of loans and 33 percent of loan dollars. In the year after the introduction of LowDoc, SBA 7(a) lending to all firms, including manufacturers, increased in lower-income zip codes by only 38 loans, or 44 percent, while increasing by 131 loans, or 110 percent, in upper-income zip codes. More than 75 percent of the increase in loans accrued to upper-income areas.

One key issue that should be explored in a small business credit needs analysis is the need for technical assistance for small businesses applying for financing. Because many small firms lack strong financial presentation skills, and may be unfamiliar with how to request development finance in particular (e.g., subordinated debt, layered financing, guarantees, and government financing), those targeting underserved markets often need to identify a source of loan packaging for eligible firms. This type of technical assistance also serves to prescreen potential borrowers so that lenders do not have to spend large amounts of time reviewing applications that are clearly not fundable. At the same time, loan packagers can tell businesses why they will not qualify for financing and what needs to be done in order to qualify. Good packagers are also experts in the locally available economic development finance programs.

By providing improved information in the loan application, loan packaging services reduce the uncertainty lenders face, reducing their overall lending risk. Loan packaging can also reduce the screening and transaction costs lenders typically face. Finally, community-based loan packagers can add substantial value to businesses and lenders alike through their knowledge of the local business environment and access to other forms of development assistance. Loan packaging by community development corporations, for example, can be combined with job training and placement services that such organizations often provide.

*Step 4: **Choose** the Best Tools for Meeting Needs and Filling the Gaps*

Small business lending tools to meet the needs of firms in underserved markets can range from organizing campaigns that target banks and government lenders who are not adequately serving modest-income neighborhoods or minority-owned businesses to developing a new community development financial institution. An important starting point is to build on the strengths of the organization taking action. If an organization's strengths lie in organizing and pushing for government policy changes, for example, it may not be well suited for developing and managing a financing program itself. If an organization identifies the need for a type of action or programming with which it has little experience, it may need to collaborate with those best suited for the tasks at hand.

Stakeholders in economic development finance and community reinvestment initiatives also need to examine what has worked in situations like theirs, both locally and around the country. This means talking to those who have developed and implemented similar programs and joining national trade organizations such as the National Association of Community Development Loan Funds, the National Congress for Community Economic Development, the National Council for Urban Economic Development, and the National Community Reinvestment Coalition. It also means doing some in-depth research about programs that target markets and financial needs similar to those identified by the stakeholders.

The next section outlines the broad types of tools that can increase access to small business financing and economic development finance.

III. Tools for Reinvestment: Advocacy and Lending for Spurring Small Business Development

While there are a wide variety of approaches to improving economic development finance and small business access to credit in modest-income urban neighborhoods and among minority-owned businesses, most fall into the following general categories:

- CRA Advocacy and Bank-Community Partnerships
- Specialized Bank Programs
- Multibank Efforts
- Government-Administered Business Financing Programs
- Community Development Lenders

CRA Advocacy and Bank-Community Partnerships

Although CRA has been used most effectively in the housing arena, a number of community reinvestment advocates around the country have utilized CRA to improve access to small business financing, and to encourage the use of economic development tools in targeted areas. Community organizations can approach banks that are, or are likely to become, involved in mergers and acquisitions to obtain formal, best effort commitments to maintain or increase lending in specific areas. In some cases, agreements are sought because a lender has done a poor job in the past of serving businesses in certain markets, while in other cases there is concern that an out-of-town institution acquiring a bank may not maintain the performance and service of the local lender. Mergers and acquisitions have the potential to adversely affecting banks' attention to small business financing and services.

Community reinvestment organizing and negotiating efforts are most successful when stakeholder organizations go through an economic development analysis outlined in Steps 1 through 3 in Part II. Community-based organizations that approach banks with a clear definition of objectives and financing needs are in a much stronger position to obtain substantive and effective agreements.

Community reinvestment agreements can provide real added value in the efforts by banks to identify, reach into, and serve new markets. One of the largest, early sets of formal CRA agreements was the 1984 Neighborhood Lending Agreements involving the First National Bank of Chicago, Harris Bank, and the Northern Trust in Chicago. During these negotiations, neighborhood activists identified long-term, affordable financing for mixed-use neighborhood buildings as a key financing need across the city. Under these agreements, large banks began offering long-term, 20- and 25-year loans on neighborhood commercial properties that had been difficult to finance. In addition, the Chicago Association of Neighborhood Development Organizations (CANDO), a city-wide coalition of neighborhood development groups, was certified as a loan packager for the programs. In exchange for screening loan applicants for credit worthiness and helping prepare loan packages, CANDO receives a share of the banks' regular loan origination

fee. The Neighborhood Lending program of each bank has an advisory board that consists primarily of representatives of neighborhood development organizations.

CRA advocacy and negotiations can be important tools to increase small business lending to targeted markets. These tools may be sufficient to deal with the distribution of conventional lending or with less profitable borrowers' access to credit. They can also be combined with incentives offered by state and local public deposit programs described below. But to address the economic development needs of many communities more fully, CRA advocacy and agreements need to be paired with specialized lending and economic development financing programs. Without such programs, banks will not generally take on the risks of more challenging projects that can create substantial numbers of jobs and stimulate significant economic development.

In 1986, the Maryland Citizen Action Coalition, a coalition of community groups, community development corporations, women's organizations, housing groups, and a credit union formed the Maryland Alliance for Responsible Investment (MARI) to confront the poor lending record of Maryland National Bank in Baltimore and surrounding areas. MARI challenged the acquisition of American Security Bank by Maryland National and, in late 1986, negotiated and executed the first major community reinvestment agreement in the city of Baltimore. MARI was concerned that Maryland National's acquisition would worsen the climate for access to small business financing in central city Baltimore neighborhoods. In the agreement, Maryland National agreed to make best efforts to lend at least $50 million over the next five years for housing and small business development, targeting 20 low- and moderate-income zip codes, primarily within the city of Baltimore. The agreement targeted small businesses with annual sales of less than $5 million, because this was the segment of the market found to be poorly served. Half of the small business financing was targeted to loans of no more than $50,000. In 1993, Nationsbank, one of the largest banks in the country, acquired Maryland National. Thus far, Nationsbank has agreed to maintain the prior commitment levels, which had been increased to $80 million from 1989 through 1995. From 1987 through early 1995, the bank had made over 200 loans totaling $15 million. Of this, more than 60 percent of the loans were for amounts of less than $50,000.

Specialized Bank Programs

Most banks provide a wide variety of products and services to a broad variety of customers. To do this, they often utilize specialized units within their organizational structures. Even within commercial lending, banks employ such units focusing on areas such as asset-based lending or middle-market companies. In the same way, some banks have identified community economic development lending as a specialized task that they can best carry out through a particular bank unit. These lenders typically seek to increase their activity in low- and moderate-income neighborhoods and lending to minority-owned firms, in large part to maintain or improve their CRA ratings. One target is businesses whose financing needs either entail a different, and perhaps more labor intensive, approach by the lender or require some sort of credit enhancement to mitigate risks or uncertainties.

Some banks create specialized programs by establishing separately regulated entities known as bank community development corporations. Bank CDCs are able to offer alternatively structured loans and even make equity investments. Typically, bank CDCs work with other parts of the parent financial institution to make loans that would not be conventionally bankable.

Whether via a separate internal unit or through a bank CDC, specialized bank units develop expertise in government economic development programs and form relationships with economic development organizations serving targeted neighborhoods. These lenders often encounter firms with less sophisticated financial skills or whose businesses fall short of the bank's conventional credit standards. By using an SBA 7(a) loan guarantee or a state or local economic development program, the lender can structure a loan the bank can make. In the case of bank CDCs, the specialized lender may structure a loan that utilizes both regular financing from the parent bank together with subordinate financing from the CDC.

The Community Development Lending Group (CDLG) is a unit of Cleveland-based Society National Bank that makes community development loans both for housing and small business projects in modest-income parts of the Cleveland metropolitan area. A significant part of CDLG's responsibility is to serve small businesses that do not meet the traditional requirements of Society's Business Loan Center, where it serves conventionally bankable customers. CDLG utilizes credit enhancements where necessary, combined with a more patient and specialized approach to less sophisticated and sometimes less mature businesses. Both the Business Loan Center and the Community Development Lending Group make loans in modest-income census tracts in the Cleveland area, but CDLG customers tend to be smaller and less established than those of the Business Loan Center, and sometimes need increased attention to record keeping, business plans, and financial projections. CDLG is more likely than other units of the bank to work with customers on these issues, to utilize credit enhancements where appropriate, and to target minority-owned businesses.

Society Bank views the type of small business lending done by CDLG as a demanding task requiring highly skilled and experienced staff, with a special commitment to development issues. A key difference between CDLG and other units of the bank lies in the effort made to work with individual businesses, to structure deals and to try to make projects happen. This does, however, increase the costs of the transaction and requires a specialized lender approach to contain these costs.

In 1993, the Community Development Lending Group made approximately 80 loans totaling more than $9.5 million to small businesses and commercial real estate projects, and about 15 loans totaling more than $5 million to churches and nonprofits. Approximately 60 percent of these were made for projects in the City of Cleveland, with the bulk of all lending going to businesses in modest-income neighborhoods in the metro area. More than 40 percent of all loans were for amounts of less than $50,000, with another 20 percent for amounts between $50,000 and $100,000. CDLG staff estimate that 70 percent of its loans utilize some type of credit enhancement such as a guarantee or subordinate loan.

Multibank Efforts

In many cases, markets and financing needs may be identified that, due to higher costs or risks, individual banks may be unwilling to serve alone, but would be willing to share with other lenders. Smaller banks might feel that they cannot afford a specialized unit themselves to address these markets, but might be able to share the costs of such activity with other lenders.

In some of these cases, banks may pool their resources and risks to create some sort of pooled lending entity. A common form for such an entity is the multibank CDC. The multibank CDC is a separately regulated institution that gains its capital from a group of banks serving similar service areas. Multibank CDCs typically focus on modest-income areas and can be organized as either for-profit or nonprofit organizations.

Bankers Small Business Community Development Corporation (Bankers CDC) is a multibank community development corporation that targets minority- and women-owned businesses as well as those located in modest-income census tracts in San Diego County. Bankers CDC provides direct financing from $5,000 to $50,000 for equipment or working capital with flexible terms. Applicants are expected to show positive cash flow and have a good credit rating, but a lack of collateral does not preclude qualification. Because the organization has seen some problems with what one loan committee member terms the "shoebox" financial record-keeping practices of some very small firms, it is instituting a technical assistance program where loans are contingent upon the borrower agreeing to undertake basic financial management training from a qualified CPA. The training is paid via an upfront escrow. The fee is then used to retain the accountant for six months to train the businessperson to maintain adequate records and financial systems, and to implement financial planning. Monthly reports are provided to Bankers CDC as a part of this process.

In its first two years of operation, Bankers CDC originated 44 loans for $1.3 million, all of them in low- or moderate-income census tracts within San Diego County, with more than one-half of the loans going to minority-owned businesses. After making 12 loans in 1993, its first year, Bankers CDC made 32 loans in 1994 for a total of $900,000.

Government-Administered Business Financing Programs

A key set of players in promoting small business lending in targeted markets are federal, state and local government agencies. One relatively easy way that state and local government can support financing of businesses in targeted markets is through the power of their treasuries.[21] State and local treasurers can promote conventional small business lending to targeted markets through strategically placing their deposits with banks who serve these markets. This often includes examining small business lending

[21] Valjean McLenighan and Malcolm Bush, *More for Our Money: A Primer on Public Deposit Programs*, Woodstock Institute, 1994.

patterns and the participation of banks in various economic development finance programs.

Treasurers can either use broad screening or incentive programs, or place a specific deposit in a participating bank for each eligible loan it makes. The latter is commonly known as a linked-deposit program. It is important to distinguish public deposit programs from traditional development finance programs that utilize credit-enhancements, such as guarantees or subordinate financing. Linked-deposit programs do not typically offer any type of credit enhancement that significantly affects the underwriting risk incurred by the lender. Rather, these programs simply reward banks for making more loans in underserved markets by the deposit of government funds, while sometimes providing a lower interest rate to borrowing firms.

In Chicago, the City Treasurer operates a linked-deposit program that awards banks for making loans to small, minority- and women-owned businesses in the city with City of Chicago deposits. For every short-term business loan of no more than $50,000 that a participating bank makes to an eligible small business, the City makes a deposit in the bank. Loans to those business types identified as most underserved and important to the city's economic development are rewarded with deposits equaling larger multiples of the loan. The deposit multiple ranges from 1:1 for small, nonminority-owned businesses to 10:1 for minority- and women-owned contractors. City Treasurer staff worked closely with an advisory committee of community and economic development organizations, as well as local banks, to develop the program. The advisory committee continues to meet periodically to review progress and offer advice on program modifications and initiatives. From 1991 through early 1995, 331 linked-deposit loans to businesses in the central city had been made under the Chicago program, with 128 going to minority-owned firms and 58 going to women-owned businesses.

Another important set of government programs are economic development finance programs, including federal SBA programs. If the financing needs identified by stakeholders include loans for businesses that are not conventionally bankable, these tools are a critical component of the reinvestment effort. Banks cannot be expected to finance businesses with shortfalls in collateral or very short operating histories without access to such programs. Other borrowers may require long-term financing that is too risky or costly for banks to offer without some sort of credit enhancement.

A relatively inexpensive and easily targeted economic development financing program that cities and states can administer directly is a capital access program. Capital access programs work by creating reserve funds for each bank making loans under the program, which enables banks to make higher-risk loans. The borrower makes a premium payment, typically from 1 to 2 percent of the loan, the bank makes a similar payment (which may be passed on to the borrower), and the government agency matches it. Together, these payments are put into the participating bank's program reserve account. Each participating bank has only one reserve account, which, as loans build, holds sizable reserves that can be drawn down to cover losses for loans processed through the program.

In addition to a direct role in financing, government agencies control access to significant operating support for technical assistance to facilitate access to financing by small businesses. The SBA's Small Business Development Center program, currently managed by the states, provides funding for organizations that train and support small businesses, including those seeking capital and credit. Some state and local governments also provide support, with their own or federal funds, for neighborhood-targeted or minority business development activities, including loan packaging and screening. In part due to political pressures, such support is not always well targeted toward underserved communities and markets, suggesting the potential for a more rational allocation of these funds.

The Connecticut Development Authority's Urbank program is an example of a state-administered capital access program that targets its lending to modest-income, and especially, urban areas. The Urbank program works by allowing banks access to subsidized portfolio insurance for eligible loans to small businesses. Small businesses unable to obtain conventional financing for a project in a targeted area are eligible for the program. Uses of funds may include owner-occupied real estate, equipment, and working capital, with working capital requests being the most common. Urbank has targeted modest-income urban neighborhoods by offering supplemental insurance for loans in the most distressed urban areas. As of March, 1995, three years after Urbank's inception, 122 loans had been processed through the program for a total of $10.4 million. Typical loan size is approximately $50,000. In 1993, the program had processed 65 loans totaling $6.9 million. Urbank is notable for its success at targeting modest-income areas and minority- and women-owned businesses, while sustaining few losses and operating a program with minimal staff.

Community Development Lenders

When conventional financial institutions, or multibank efforts, are insufficient to address small business financing needs, even with government credit enhancements and incentives, then a specialized community development lending organization may be an important tool for meeting economic development objectives. These might take the form of a community development financial institution, such as a community-based revolving loan fund or credit union, or a quasi-governmental organization.[22]

Typically, community development lenders are nonprofit organizations that include targeted economic development as a part of their mission. Some cities have recognized that municipal government provides a poor environment for business development financing activities and so have spun-off quasi-governmental development organizations or have contracted with community-based organizations. This poor environment includes the difficulties caused by direct political involvement in the lending process and by the delays and limited responsive-ness that plague many municipal agencies.

[22] Kathryn Tholin, *Community Development Financial Institutions: Investing in People and Communities, Woodstock Institute*, 1994

Another problem is the trouble that governments have in targeting efforts where they are most needed. Political pressures often push them to spread their efforts across all political subdivisions, regardless of need.

While both community-based and quasi-governmental efforts can prove powerful tools in delivering development finance, well designed community-based institutions are likely to prove more effective than government-based ones. This is because community-based efforts are less constrained by the sometimes misplaced requirements of more direct government involvement. They also benefit from the direction of community stakeholders who sit on their governing boards, from the ability to recruit highly qualified staff in an independent fashion, and from philanthropic support.

> The Southern Dallas Development Corporation (SDDC) is a nonprofit, 501(c)(3) organization that was created in 1989 to promote the economic development of southern Dallas, including the creation of jobs for low- and moderate-income residents of the area. Southern Dallas is the predominantly modest-income minority segment of Dallas, with a population of 450,000, of which approximately 75 percent is African-American and Latino. SDDC's primary activities include four business financing programs, which address a spectrum of small business needs and stages of development and focus on firms owned by African-Americans and Latinos. In addition to business financing, SDDC also conducts other economic development activities including real estate development projects, entrepreneurial seminars and events, and small business networking functions. SDDC is governed by a board of 25 directors composed of approximately one-third neighborhood organizations, one-third chamber of commerce and business groups, and one-third individuals appointed by city councilpersons from southern Dallas and by the Mayor.
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> To get the organization off the ground, the City of Dallas committed to a multiyear contract with SDDC, which included the provision of a loaned executive to direct the organization, $800,000 over three years in Community Development Block Grant (CDBG) funds for operating support, and $3 million for loan capital. The organization began by focusing on lending funds from its CDBG revolving fund. In its first three years, the organization made loans from this fund at a rate of just over $1 million per year. In the next four years, SDDC created a multibank CDC, an SBA microloan program, and an SBA 504 development company program to enable it to increase the spectrum and magnitude of business financing activity.
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> As of March, 1995, SDDC and its affiliates had made 204 loans totaling more than $14.6 million. Approximately 80 percent of these loans went to firms located in modest-income neighborhoods, primarily southern Dallas. Of the 204 loans, 149 went to minority-owned businesses, including 107 to firms owned by African-Americans and 35 to firms owned by Latinos. In fiscal 1994, a year in which all programs were in operation, SDDC and its affiliates made 73 loans totaling $3.8 million.

Next Steps

Not every successful capital-based program for spurring targeted small business development has consciously gone through each of the strategic stages described in this publication. However, many of the strongest efforts have encountered the issues

described above at some point in their development, although perhaps in a less deliberate way or in a different order. Those interested in exploring small business development finance tools in more depth should consult a companion publication, *Small Business Lending for Economic Development II: Model Urban Programs,* which provides in-depth descriptions of 11 model programs around the country as well as lessons from these and other efforts. The appendix also lists a variety of additional reference materials for strategizing around targeted small business financing.

The general strategic steps laid out in this report should help those concerned with economic development in their communities consider and think through a capital-based strategy for small business development. There is a clear advantage to begin such thinking by identifying the ultimate economic development objectives and targeted markets. These two steps will pave the way for successfully ascertaining financing needs and choosing the appropriate type of advocacy or development tool to address these needs.

Appendix: Reference Materials for Further Work on Small Business Financing for Targeted Urban Economic Development

Theory and Examples of Small Business Lending and Economic Development Finance

Credit Where It's Due, by Julia Ann Parzen and Michael Hall Kieschnick, Temple University Press, 1992

Banking on Black Business, by Timothy Bates, Joint Center for Political and Economic Studies, 1993

Financing Economic Development: An Institutional Response, by Richard D. Bingham, Edward W. Hill, and Sammis B. White, Newbury Park, CA: Sage Publications, 1990

Evidence and Information on Access to Credit for Small Businesses In Urban Areas

Banking on Black Business, by Timothy Bates, 1993

Evidence and Information on Government Business Financing Programs

Moving to Economic Development: A New Goal for SBA Loan Programs, by Daniel Immergluck, Woodstock Institute, 1995

Bidding for Business: Are Cities and States Selling Themselves Short? by William Schweke, Carl Rist, and Brian Dabson, Corporation for Enterprise Development, 1994

Information on Existing Small Business Financing Programs in Urban Areas

Small Business Lending for Economic Development Volume II: Model Urban Programs, by Daniel Immergluck and Samantha Weinstein, Woodstock Institute, 1995

Model Economic Development Financing Programs, The Development Fund, San Francisco, 1993

Credit Where It's Due, by Julia Ann Parzen and Michael Hall Kieschnick, 1992

The Community Reinvestment Act

Making CRA Work For You, by Kathryn Tholin, Woodstock Institute, 1991

Community Development Financial Institutions

Community Development Financial Institutions: Investing in People and Communities, by Kathryn Tholin, Woodstock Institute, 1994

Public Deposit Programs

More for Our Money: A Primer on Public Deposit Programs, by Valjean McLenighan and Malcolm Bush, Woodstock Institute, 1994